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Financial Stability Improvement Act of 2009: The First Step Toward Financial Reform

by John Dembeck and Paul L. Lee

On December 11, 2009, the U.S. House of Representatives passed H.R. 4173, the "Wall Street Reform and Consumer Protection Act of 2009," a broad ranging financial reform measure. The passage of H.R. 4173 represents the first key step toward potential regulatory reform legislation in the U.S. The Senate Committee on Banking, Housing and Urban Affairs is separately working on its own version of comprehensive financial reform legislation. The House bill as passed includes many of the elements of the financial reform package proposed by the Obama Administration earlier this year. Along with the creation of a Consumer Financial Protection Agency and new regulation of OTC derivative transactions, the bill contains as Title I the "Financial Stability Improvement Act of 2009" (the "Act"). This article summarizes some of the key provisions of the Act, including those that establish a new council of U.S. regulators to oversee the U.S. financial industry, a mechanism for identifying systemically important financial companies and imposing stricter standards on such financial companies and new procedures for resolving systemically important financial companies.

Financial Services Oversight Council

Council. The Act establishes the Financial Services Oversight Council. Voting members of the Council are the Secretary of the Treasury, as Chairman, the Chairmen of the Federal Reserve Board, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation and the National Credit Union Administration, the Comptroller of the Currency, the Director of the Office of Thrift Supervision (until the functions of that office are transferred), the Director of the Federal Housing Finance Agency and the head of the new Consumer Financial Protection Agency. Nonvoting members of the Council are the head of a newly created Federal Insurance Office in the Treasury Department, a state insurance commissioner, a state banking supervisor and a state securities commissioner, each to be designated by a selection process set by relevant state bodies and to serve a 2-year term.

Duties. The duties of the Council include: (i) monitoring the financial services marketplace to identify potential threats to the stability of the U.S. financial system; (ii) identifying potential threats to the stability of the U.S. financial system that do not arise out of the financial services marketplace; (iii) developing plans (and conducting exercises in furtherance of those plans) to prepare for potential threats identified under items (i) and (ii); (iv) subjecting financial companies and financial activities to stricter prudential standards in order to promote financial stability and mitigate systemic risk; (v) issuing formal recommendations that a Council member agency adopt stricter prudential standards for firms it regulates to mitigate systemic risk; (vi) monitoring international regulatory developments, including insurance and accounting developments; and (vii) resolving jurisdictional disputes between Council members that are federal agencies.

Identification. The Council, in consultation with the Federal Reserve and any other primary financial regulatory agency (as defined under the Act, this term includes a

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What's Inside

The FSA's Extended Approved Persons Regime

by Jeremy Hill and Edite Ligere

In July 2009, the Financial Services Authority (the "FSA"), the UK's financial services regulator, published its Policy Statement 09/14 "The Approved Persons Regime - Significant Influence Function Review". This introduced a number of far-reaching changes into the UK approved persons regime (the "AP regime"). The extended AP regime applies to both UK and overseas firms. It came into force in the UK on 6 August 2009 with a six month transitional period in respect of overseas firms.

Background to the AP Regime

By way of background, the AP regime applies to individuals who perform key functions, known as "controlled functions", within FSA-regulated firms. Examples of controlled functions, which the FSA has identified as key to the AP regime, include:

(i) the director function;

(ii) the non-executive director function; and

(iii) the significant management function.

In respect of the director function, the term "director" under English law includes any person occupying the position of a director, by whatever name called, section 250 of the Companies Act 2006 ("CA 2006"). In practice, there is a distinction between executive directors (who are either full or part-time employees of the company), non-executive directors (who are not employed by the company) and shadow directors, defined by section 251(1) of the CA 2006 as: "persons in accordance with whose directions or instructions the directors of the company are accustomed to act". Persons who give advice to the directors of a company in a professional capacity are not regarded as shadow directors. Under the CA 2006, the general duties of a director apply to anyone occupying the position of a director by whatever name called.

For completeness, the Combined Code on Corporate Governance (which is the key source of corporate governance recommendations for UK listed companies) describes the role of a non-executive director in the following terms:

> "…as part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy. Non-

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executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, executive directors, and in succession planning".

The significant management function generally applies to an individual other than a director:

(a) who is employed by a firm or a body corporate within a group of which the firm is a member;

(b) to whom the governing body of the firm, or a member of the governing body of the firm, has given responsibility, either alone or jointly with others, for management and supervision;

(c) who, if the individual is employed by the firm, reports directly to:

  (i) the governing body; or

  (ii) a member of the governing body; or

  (iii) the chief executive; or

  (iv) the head of a significant business unit; and

(d) who, if the individual is employed by a body corporate within the group, reports directly to a person who is the equivalent of a body or person referred to in (c).

It has now been extended as discussed below.

In order to become an approved person (an "AP"), an applicant must satisfy the FSA that he is a "fit and proper person". In assessing this, the FSA looks at the applicant's honesty, integrity and reputation as well as his competence and capability. Persons covered by the AP regime are bound by the FSA's Statements of Principle and the Code of Conduct for Approved Persons ("APER"). Approved Persons are personally responsible for complying with the requirements imposed on them. They are subject to the FSA's disciplinary powers, which include the imposition of fines and, where appropriate, prosecution.

The extended director function is intended to catch not only the directors (executive and non-executive) of the parent or holding company but also anyone else whose decisions or actions are regularly taken into account by the FSA-regulated firms' governing body.

The Extended AP Regime

As of 6 August 2009, the FSA has:

(i) extended the scope and application of the director function (CFI) and the non-executive director function (CF2) to include those persons employed by an unregulated parent undertaking or holding company whose decisions or actions are regularly taken into account by the governing body of a regulated firm;

(ii) extended the definition of the significant management controlled function (CF29) to, amongst other things, include all proprietary traders who are not senior managers but who are likely to exert significant influence on an FSA-regulated firm; and

(iii) amended the application of the AP regime to UK branches of overseas firms based outside the EEA.

The extended director function is intended to catch not only the directors (executive and non-executive) of the parent or holding company but also anyone else whose decisions or actions are regularly taken into account by the FSA-regulated firms' governing body. Consequently, it is not the *position* held by a person within the parent or holding company that will determine whether they fall within the extended definition, but the *function* fulfilled in relation to the FSA-regulated entity.

The FSA's Policy Statement 09/14 provides that:

"Where groups operate under a matrix managed structure, a firm will need to consider which of the significant influence functions is the most appropriate. There may be cases, for example, where a person is already approved under CF29 but whose function falls within the extended CF1 definition in which case they will cease to fall within CF29 and need to seek approval for CF1.

Shareholders are not included in the extended definition of CF1 or CF2. However, our rules deal with apportionment and responsibility. Should a shareholder take a more "hands on"

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approach and exercise significant influence, it may be appropriate for him or her to be approved for a significant influence controlled function, for example a senior manager (the firm thereby having clear and appropriate apportionment of responsibilities)."

The FSA's original proposals included further clarification of the role of non-executive directors. However, this is now likely to be addressed in the FSA's consultation paper on governance expected to be published at the end of 2009.

Overseas Firms

An overseas firm which maintains an establishment in the UK from which FSA-regulated activities are carried on is subject to the following controlled functions:

(i) the *director function* where the person performing that function:

(a) has responsibility for the regulated activities of a UK branch which are likely to enable him to exercise significant influence over that branch; or

(b) is someone whose decisions or actions are regularly taken into account by the governing body of that branch.

(ii) the *non-executive director function* where the person performing that function:

(a) has responsibility for the regulated activities of a UK branch which is likely to enable him to exercise significant influence over that branch; or

(b) is someone whose decisions or actions are regularly taken into account by the governing body of that branch.

(iii) the *chief executive function*;

(iv) the *required functions*;

(v) the *systems and controls functions*;

(vi) the *significant management function* in so far as the function relates to:

(a) designated investment business other than dealing in investments as principal; or

(b) processing confirmations, payments, settlements, insurance claims, client money and similar matters in so far as this relates to designated investment business; and

(vii) the *customer function*.

Examples of the Director Function

Examples of the director function where a firm is a body corporate (other than a limited liability partnership) include:

(i) a chairman of an audit committee of a parent undertaking or holding company of a UK firm where that audit committee is working for that UK firm (that is, functioning as the audit committee for the group); or

(ii) a director (other than a non-executive director) of a parent undertaking or holding company of a UK firm exercising significant influence by way of his involvement in taking decisions for the UK firm; or

(iii) an individual (such as a senior manager) of a parent undertaking or holding company of a UK firm who is responsible for and/or has significant influence in setting the objectives for the remuneration of executive directors of that UK firm; or

(iv) an individual who is a director (other than a non-executive director) or a senior manager of a parent undertaking or holding company of a UK firm who is accustomed to influencing the operations of that UK firm, and acts in a manner in which it can reasonably be expected that an executive director or senior manager of that UK firm would act; or

(v) an individual of an overseas firm which maintains an establishment in the United Kingdom from which regulated activities are carried on where that individual has responsibilities for those regulated activities which are likely to enable him to exercise significant influence over the UK branch.

Examples of the Non-executive Director Function

Examples of the non-executive director function where a firm is a body corporate include:

(i) an individual who is a non-executive director of a parent undertaking or holding company who takes an active role in the running of the business of a UK firm, for example, as a member of a board or committee (on audit or remuneration) of that firm; or

(ii) an individual who is a non-executive director of a parent undertaking or holding company having significant influence in setting and monitoring the business strategy of the UK firm; or

(iii) an individual who is a non-executive director of a parent undertaking or holding company of a UK firm involved in carrying out responsibilities such as scrutinising the approach of executive management, performance, or standards of conduct of the UK firm; or

(iv) an individual who is a non-executive director of a parent undertaking or holding company of a UK firm who is accustomed to influence the operations of the UK firm, and acts in a way in which it can reasonably be expected that a

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non-executive director of the UK firm would act; or

(v) an individual who is a non-executive director of an overseas firm which maintains a branch in the United Kingdom from which regulated activities are carried on where that individual has responsibilities of those regulated activities which are likely to enable him to exercise significant influence over the UK branch.

The current AP regime has far-reaching consequences not only for persons within the UK/EEA but also for individuals outside the UK who fall into one or more of the above categories. These consequences are likely to come as a particular surprise to persons employed by an unregulated parent or holding company of an FSA-regulated firm whose decisions or actions are regularly taken into account by the governing body of the FSA-regulated firm. Consequently, firms need to give careful consideration on a case by case basis to who may be caught by the AP regime. Firms should also engage in a dialogue with the FSA about the possible need to apply for AP status in respect of one or more persons as soon as there is any prospect of the AP regime being triggered.

Examples of the Significant Management Function

The significant management function specifically does not include any of the activities described in any other controlled function. The FSA anticipates that there will be only a few firms needing to seek approval for an individual to perform the significant management function. In most cases, the individuals who are approved for the governing functions, required functions and, where appropriate, the systems and controls function, are likely to exercise all the significant influence at senior management level.

However, there may be circumstances where a manager who is based overseas and is not approved by the FSA will be performing the significant management function. Such a person will need the FSA's approval. The FSA's guidance provides that, as a general rule, where an overseas manager is responsible for strategy in relation to a branch of an FSA-regulated firm or an FSA-regulated firm which is part of an overseas group, he will not need to be an approved person. However, where he is responsible for implementing that strategy in the United Kingdom, and has not delegated that responsibility to a senior manager in the United Kingdom, he is likely to be performing that controlled function and require the FSA's approval.

Changes to the AP Application Process

Applications must be submitted by, or on behalf of, the firm, not by the candidate. Where the candidate works for the FSA authorised firm's parent or holding company, the application must be submitted to the FSA by that parent or holding company. In addition to filling out a detailed form, which was recently amended to tighten the application process for approving individuals to perform significant influence functions, applicants for AP status are increasingly being interviewed by the FSA in order to assess fitness and propriety. Such interviews are usually held at the FSA's offices and last about 90 minutes. They cover a range of issues that are relevant to the FSA's approval decision, including the candidate's view of the main risks facing the firm and the best way of managing such risks. Since October 2008, the FSA has carried out over 120 interviews for "significant influence" posts. Nine applications have been withdrawn as a result of such interviews.

The extended AP regime captures circumstances where the de facto management influence and control in respect of an FSA-regulated firm are exercised by the management of a non-UK parent company.

The application forms now require firms to provide supplementary information based on the competence and capability of the candidate. In particular, firms have to provide information about:

(i) why the candidate is competent and capable to perform the role applied for; why the appointment complements the firm's business strategy, activity and the markets in which it operates; and

(ii) how the appointment was agreed, including details of any discussions at governing body level where this is appropriate.

Further, the candidate and the firm must confirm that the regulatory responsibilities of the proposed role have been explained to and understood by the candidate. On several occasions, the FSA has emphasised that it expects to have a dialogue with the firm in question before an application for AP status is submitted. Such a dialogue should be started sooner rather than later.

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FSA's Enforcement Trends

The FSA has shown itself increasingly willing to take enforcement action against APs. By way of an example, in the third quarter of 2009, the FSA brought several criminal insider dealing prosecutions against APs. It has also imposed a number of fines on APs, for example, on a former stockbroker for using insider information about an AIM-traded company to encourage his clients to buy its shares.

The proposals put forward by the government in the Financial Services Bill, unveiled in the Queen's Speech on 18 November 2009, among other things, add "financial stability" to the FSA's regulatory objectives and extend the FSA's already broad information gathering and disciplinary powers (including those relating to the performance of controlled functions without approval).

Conclusion

The extended AP regime captures circumstances where the de facto management influence and control in respect of an FSA-regulated firm are exercised by the management of a non-UK parent company. Overseas owners and managers of FSA-regulated firms are now faced with the prospect of either:

(a) becoming approved by the FSA where they fall into one or more of the "controlled functions" categories described above; or

(b) accepting that decision-making and the exercise of significant influence relating to an FSA-regulated firm will have to be vested in persons other than themselves who are approved by the FSA.

U.S. and other overseas firms may wish to consider having a regulatory compliance audit to ensure that all relevant decision-makers/persons who exercise significant influence in respect of an FSA-regulated firm comply with the requirements of the FSA's extended AP regime.

The AP regime should be given serious consideration by UK and overseas firms as well as the ever increasing class of individuals who could be caught by the extended AP regime. ■

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Some Important Things to Know About a New York Regulation 114 Trust

By John Dembeck

A U.S. insurer that reinsures risks with an unauthorized reinsurer may generally obtain credit for reinsurance ceded on its U.S. statutory financial statements only if the unauthorized reinsurer posts security in one of three permitted forms – funds withheld, a letter of credit or assets deposited in a reinsurance trust. A U.S. ceding insurer that is licensed to do an insurance business in New York, or is accredited as a reinsurer in New York, is subject to New York reinsurance credit rules in addition to the reinsurance credit rules of its domiciliary state. If the reinsurer elects or is required to post security in the form of assets deposited in a reinsurance trust, the trust arrangement must satisfy New York's reinsurance trust rules set out in New York's Regulation 114 in order for the ceding insurer to obtain reinsurance credit in New York.

Regulation 114 trusts are well known in the reinsurance community – in fact, many people refer to reinsurance trust arrangements generically as "Regulation 114 trusts," much the same way people have referred to photocopies as "Xerox copies" or tissue as "Kleenex". While the actual provisions of Regulation 114 are well known and accessible, opinions of the New York Insurance Department (the "Department") construing provisions of Regulation 114 may not be so widely known. The purpose of this article is to summarize important Department opinions issued in recent years construing the provisions of Regulation 114 or that impact its implementation.

Quantitative Investment Limits

Certain assets are permitted to be deposited in a Regulation 114 trust – cash, certificates of deposit and "investments of the types specified" in New York Insurance Law Section 1404(a)(1) (government obligations), (a)(2) (obligations of U.S. institutions rated A or higher or NAIC 1), (a)(3) (preferred stock of U.S. institutions that have obligations that qualify under Section 1404(a)(2)), (a)(8) (equity interests – including stock of U.S. institutions that have obligations and preferred stock that qualify under Sections 1404(a)(2) and (a)(3) and are

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registered securities) and (a)(10) (investment companies subject to specified criteria). Section 1404(a) also includes some quantitative investment limitations – for example, Section 1404(a)(2) limits the amount that can be invested in the obligations of any single institution to 5% of the admitted assets of the investing insurer. Do any of the quantitative limitations of Section 1404(a) apply to permitted Regulation 114 trust assets? In a February 27, 2003 opinion, the Department opined that the quantitative limitations of Section 1404(a) do not apply to Regulation 114 permitted assets. This opinion is consistent with the wording of the regulation, which permits trust assets "of the types" specified in certain paragraphs of Section 1404(a). The phrase "of the types" speaks to qualitative standards but not quantitative standards.

> **While the actual provisions of Regulation 114 are well known and accessible, opinions of the New York Insurance Department (the "Department") construing provisions of Regulation 114 may not be so widely known.**

"A" Rated U.S. Corporate Obligations

Under Regulation 114 and New York Insurance Law Section 1404(a)(2), obligations of a U.S. institution are permitted trust assets if they are (i) issued by a solvent institution, (ii) not in default as to principal or interest and (iii) rated "A" or higher. In an August 13, 1999 opinion, the Department opined that an obligation rated "A-" by Standard & Poor's or "A3" by Moody's would be of sufficient quality to satisfy this requirement. In addition, in a July 23, 2004 opinion, the Department opined that if an obligation is rated "A" by one rating agency but less than "A" by another rating agency, the investment will also satisfy this requirement, since one rating agency still rates it "A" or higher.

Trust Assets Must Be U.S. Dollar Denominated

In an October 17, 2008 opinion, the Department opined that assets placed in a Regulation 114 trust must be U.S. dollar denominated. As the reason for this conclusion, the Department cited (i) the fact that only U.S. cash or certificates of deposit are permitted Regulation 114 trust assets, (ii) the fact that foreign currency denominated assets would run counter to the intent and purpose of Regulation 114 and (iii) an older opinion that concluded that an obligation of a U.S. issuer denominated in a foreign currency would not qualify as an "obligation of an American institution" under New York Insurance Law Section 1404(a)(2) because of the exchange rate fluctuation and currency blockage risks inherent in foreign currency denominated assets.

Asset Acquisition Test

In the case of rated securities as permitted Regulation 114 trust assets, nothing in Regulation 114 specifies the point in time at which the rating requirement is measured. In a September 30, 2009 opinion, the Department opined that the requirements set forth in New York Insurance Law Section 1401(b) apply in the case of assets deposited in a Regulation 114 trust – "All financial tests and other requirements for the making of any investment are satisfied if complied with on the date of acquisition by the insurer, except as otherwise permitted by this chapter or by regulation." ■

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Practice Points

- Permitted Regulation 114 trust assets only need to satisfy the qualitative but not the quantitative limitations of the cited paragraphs of Section 1404(a).
- Any U.S. corporate debt security that is rated "A" by at least one rating agency will qualify as a permitted Regulation 114 trust asset – including those rated A- to AAA and A3 to Aaa.
- All assets deposited in a Regulation 114 trust must be U.S. dollar denominated.
- Where a permitted Regulation 114 asset is subject to a qualitative standard such as a minimum rating requirement, the asset need only meet that standard on the asset's acquisition date.

New International Reforms of Financial Institution Compensation

By Beth Pagel Serebransky, Gregory J. Lyons, Satish M. Kini, Paul L. Lee and Charity Brunson Wyatt

Compensation practices at financial institutions around the world are facing heightened scrutiny and new regulatory intervention in the wake of September's G-20 charge for reform. In "A Framework for Strong, Sustainable, and Balanced Growth," the G-20 leaders called for immediate and coordinated international implementation of stricter rules aimed at correcting compensation practices perceived to encourage excessive risk-taking. While participating countries are responding swiftly to the directive, uncertainty and international dissonance persist. Despite the disagreement, however, the compensation guidance developing across the globe provides some evidence that nations are, at least to a degree, attempting the global coordination sought by the G-20.

G-20 Compensation Framework

G-20. At the summit of the G-20 held in Pittsburgh in September 2009 (the "Pittsburgh Summit"), the G-20 leaders endorsed the compensation practices recommended by the Financial Stability Board ("FSB") in its April 2009 report on strengthening financial systems. (For further discussion of the G-20 compensation framework, see the October 2009 issue of the *Financial Institutions Report*, available at www.debevoise.com) While most FSB recommendations take the form of principles and best practices, the FSB submitted an implementation standards guide (the "Standards") to the Pittsburgh Summit that also proposed some formulaic pay structures. The Standards suggested that 40-60% of variable compensation should be payable under a deferral period of at least three years; for the most senior management and highest paid employees, this percentage should be above 60%. Further, the Standards recommended that more than 50% of variable compensation be awarded in shares.

The framework ultimately adopted by the G-20, however, focuses on principles, rather than incorporating the specific formulae recommended by the FSB. The G-20 directive encourages institutions to align compensation with long-term value creation rather than risk-taking by establishing a variable pay structure that accounts for risk and performance, with a significant portion of variable compensation deferred and subject to clawback, and no multi-year guaranteed bonuses. The mandate further calls for strong disclosure, independent compensation committees, supervisors with meaningful power to review and revise compensation policies and pay policies that do not allow variable compensation based on net revenues to adversely affect a firm's capital base.

International Disparity in Compensation Reform Measures

The G-20 leaders' statement called for countries to act together "to reach agreement on an international framework of reform." Although participating countries seem to agree on the necessity of reform, they have not completely concurred in how to achieve it. Some countries are implementing the framework through strict formulae and rigid caps, while others are simply providing high-level principles for guidance. This discrepancy has led to concern about the potential impact of regulatory inconsistency.

Firms in countries with stricter compensation rules are worried that key, talented executives will flee to countries with looser regulations, or to unregulated entities like hedge funds, making their country less desirable and their companies less competitive globally. Individual firms that have received government assistance are similarly apprehensive that the more stringent rules to which they are subject will cause "brain drain" and undermine their ability to compete for new leaders.

International firms also face the difficulty of compliance with multiple, inconsistent frameworks. In many countries, new regulations are meant to apply, at least to some degree, to institutions with operations in that country, in addition to those based there, forcing multinational companies to keep track of and comply with several regimes.

> **In a November 2009 follow-up meeting in Scotland, the G-20 leaders recommitted to "urgently" incorporate FSB standards within each nation's framework.**

Global Implementation Highlights

European Commission. The European Commission's Capital Requirements Directive proposes a set of new rules on EU compensation policies. The directive, when finalized, will establish a binding obligation for financial institutions to establish compensation policies consistent with sound

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and effective risk management. The rules will look to the principles established by the Committee of European Banking Supervisors (the "CEBS") to provide guidance as to how banks can meet the obligation, and how supervisors can assess compliance. Supervisors will be empowered with a variety of means to ensure the observance of financial institutions.

In April 2009, the CEBS published a set of non-formulaic principles for compensation policy with the goal of institutional implementation by the end of the third quarter of 2009. The high-level principles include establishing: (1) a long-term-focused compensation policy that does not encourage excessive risk-taking; (2) internal transparency and adequate external disclosure; (3) strong management supervision and review of compensation policy; (4) performance-related pay that accounts for both individual and collective performance and is risk-adjusted; (5) a reasonable proportionality between base pay and bonus; and (6) deferral of a significant portion of bonuses.

France. The French government began addressing financial institution compensation long before the Pittsburgh Summit. In February 2009, France took action to strictly define the internal decision-making processes for compensation, improve transparency and spread the payment of variable compensation. After the Pittsburgh Summit, the French government has strengthened its stance on banker bonuses, in hopes of setting a standard for other G-20 participants.

In November 2009, France announced an aggressive two-tiered rule structure for bonuses. A stricter set of rules applies to French banks only, wherever they operate. For French banks, at least 50-60% of bonuses must be paid in deferred equity that will not vest for four years. Additionally, at least half of variable compensation must be paid in shares rather than cash. A second set of more lenient rules will apply to the French operations of foreign banks, as well as to France-based banks. Under this regime, banks will be required to publish compensation details annually, outlining the split between fixed and variable pay. Guaranteed multi-year bonuses are prohibited, and all banks must comply with general rules regarding transparency and strengthening internal audits on pay.

> **Hong Kong proposed rules ... [that] require that top executive bonuses be deferred for at least three years and subject to clawback in the case of future losses.**

Germany. Like France, Germany began tackling executive compensation prior to the Pittsburgh Summit. Its October 2008 bank-rescue plan included, among other restrictions, an executive pay cap of 500,000 euros at firms receiving government assistance. Since then, Germany has added principles-based regulation encompassing all German banks and financial services institutions in the August 2009 revision of its "Minimum Requirements for Risk Management" ("MaRisk"). The new MaRisk, which implements FSB recommendations, requires that the variable compensation of employees in high-risk positions be tied to long-term institutional success rather than individual short-term profits. It also requires that bonuses be subject to clawback for post-bonus risks. German financial institutions must implement these requirements by December 31, 2009.

Germany has also established a new set of compensation rules applicable to all industries. The Act on the Appropriateness of Management Board Compensation ("VorstAG") took effect in August 2009. It includes new rules for determining management board compensation and requires German listed stock corporations to establish a compensation structure that advances the long-term health of the company. It also emphasizes the need for improved external transparency, and the supervisory board's responsibility for management board compensation. The requirements will not apply retroactively to management contracts already in force, but contract extensions that occur after the VorstAG took effect will need to comply.

Hong Kong. Hong Kong proposed rules for compensation at financial institutions that do not extend to prescribing compensation levels or caps on pay. However, the rules do require that top executive bonuses be deferred for at least three years and subject to clawback in the case of future losses. Additionally, guaranteed minimum bonuses are generally prohibited.

The proposed rules also require that pay for employees tasked with risk control be independent of the performance of the units they supervise. Further, the banks' boards are directed to establish clear policies for compensation of all employees that will not encourage excessive risk-taking. The proposed rules, which will be made formal by the end of 2009 for 2010 implementation,

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cover all Hong Kong-incorporated banks, as well as the Hong Kong operations of overseas-incorporated banks.

Switzerland. With new rules released in November 2009, Switzerland moved its compensation focus towards long-term profitability. The rules apply only to large Swiss institutions. In addition to regulating the seven biggest banks, they also take in the five top insurers. The rules avoid imposing a cap on bonuses, but will require a stricter link between compensation and performance, and that a significant portion of bonuses be deferred. The fact that small banking firms will not be covered by the regulations is seen as a plus by the Swiss banking lobby. The insurance lobby, however, is concerned that the insurers will be at a competitive disadvantage internationally. The new rules take effect on January 1, 2010.

United Kingdom. Just weeks after the Pittsburgh Summit, the UK's five largest banks pledged to comply with the Financial Services Authority ("FSA") Rule on remuneration. The rule largely accords with the FSB's standards, and includes disclosure, deferral and clawback requirements. The new rule applies a formulaic approach for employees with a material impact on risk, mandating that 40-60% of variable compensation must be deferred over three years, with at least 50% received in shares. The rule will go into effect on January 1, 2010, and will include in its purview 2009 performance-based bonuses.

Additionally, a Financial Services Bill (the "Bill") is in the works that, if passed, will give the FSA power to void specific contracts that, in the FSA's view, give UK bankers exorbitant bonuses or reward excessive risk-taking. The Bill will also authorize the FSA to require UK banks to renegotiate compensation packages that violate its pay code, and fine banks that persist in extending unwarranted amounts. While the FSA does not currently police individual contracts, whether or not the Bill passes, beginning in January 2010, the FSA's own new rules will allow it to intervene when a bank's general compensation policy is not in line with effective risk management. (For more on the Financial Services Bill, see our client update *Highlights from the Financial Services Bill 2009*, dated December 3, 2009, available at www.debevoise.com.)

[T]he Fed will immediately begin conducting a review of incentive compensation practices and incorporate its findings into bank ratings.

United States. In October 2009, the U.S. Federal Reserve (the "Fed") issued proposed guidance aimed at cultivating incentive pay practices consistent with bank safety and soundness. While the guidance is not yet finalized, the Fed is urging banks to start overhauling their employees' pay packages as soon as possible. The principles will apply to all banking organizations supervised by the Fed, including the U.S. operations of foreign banks, and will extend to all employees who can individually or collectively expose a firm to material risk.

The Fed has proposed guiding principles rather than numerical requirements. For example, the Fed's proposal does not establish percentage ranges of variable compensation or shares. The principles urge financial institutions to establish compensation practices that will curb excessive risk-taking. The principles suggest means of achieving this end, including: risk-adjustment of awards, deferral of payment, longer performance periods and strong corporate governance. The principles are to be applied on a case-by-case basis, taking into account the organization's structure, needs and abilities. To ensure compliance, the Fed will immediately begin conducting a review of incentive compensation practices and incorporate its findings into bank ratings. (For more on the Financial Services Bill, see our client update *Don't Bank on the Status Quo: Federal Reserve to Regulate Incentive Compensation*, dated October 26, 2009, available at www.debevoise.com.)

Certain U.S. financial institutions are also subject to Troubled Asset Relief Program ("TARP") supervision. A TARP special master (the "Special Master") is tasked with overseeing compensation at the remaining seven U.S. firms, which include several financial institutions, that received exceptional TARP assistance. The Special Master's first ruling, released in October 2009, addressed the compensation of the 25 most highly paid employees at each of those firms. The ruling focused on reforming pay practices to align compensation with long-term value creation and financial stability. Some implementation methods include: a reduction of cash compensation by more than 90% and total compensation by more than 50%; a cash salary cap of $500,000 for most employees; and incentive compensation paid in the form of long-term restricted stock, contingent on performance and TARP repayment.

In his next set of decisions, due in December 2009, the Special Master will rule on the

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compensation structures at the seven corporations for their next 75 highest-paid employees. This evaluation will focus on structure, rather than individual pay packages, and could set a broader precedent for executive pay in general.

New Rules Clash with Existing Regulations

Incompatibility with preexisting tax and other regulations is another potential problem. In the U.S., for example, new regulations directing long-term payouts threaten to clash with existing deferred compensation rules that encourage short-term disbursements, like Internal Revenue Code Section 409A. Clawback provisions, also favored under the new rules, implicate negative tax consequences that the existing U.S. tax code is not set up to redress.

Agencies are aware of the need for coherence, and we are hopeful that they will take action. The demand for immediate compliance with new rules, however, leaves companies in an uncomfortable position as they are forced to modify existing compensation structures before conflicts have been resolved.

Conclusion

Overall, the G-20 leaders appear optimistic that the new compensation policy efforts will achieve increased financial stability and correct the perceived flaws in incentive schemes that they believe contributed to the financial crises. In a November 2009 follow-up meeting in Scotland, the G-20 leaders recommitted to "urgently" incorporate FSB standards within each nation's framework. They also reiterated the need for immediate implementation of the FSB's sound compensation practices by individual firms. The FSB is currently assessing implementation and will report back to the G-20 in March 2010 with progress thus far and further proposals, if necessary. For now, countries are expected to continue finalizing and executing their new rules. Financial institutions, meanwhile, must seek to immediately understand and comply with the new, sometimes inconsistent, cross-border regulations, even as they wait for the current regulatory landscape to coalesce. Nonetheless, in response to the greatest global financial crisis in decades, there is at least some indication that the individual countries are heeding the G-20's direction of a coordinated response to issues affecting an increasingly global marketplace. ■

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domestic state insurance regulator) that regulates the financial company or a subsidiary of such company, and in the case of a financial holding company that is an insurance company, the Federal Insurance Office, is to subject a financial company to stricter prudential standards if the Council determines that material financial distress at the company could pose a threat to financial stability or that the nature, scope, size, scale, concentration, interconnectedness or mix of the company's activities could pose such a threat.

Bank Holding Company Act Application. A financial company subject to stricter standards that does not own a bank (as that term is defined in section 2 of the Bank Holding Company Act of 1956) and that is not a foreign bank or company treated as a bank holding company under the International Banking Act of 1978, will be subject to section 4 (activity restrictions), certain subsections of section 5 (administration) and section 8 (enforcement) of the Bank Holding Company Act. If such a financial holding company conducts activities that do not comply with section 4 of the Bank Holding Company Act, it will be required to establish or designate an intermediate holding company under a new section 6 to be added to the Bank Holding Company Act through which it will conduct activities that are financial in nature or incidental thereto under section 4(k) of the Bank Holding Company Act. Before being required to establish a section 6 holding company, a financial holding company subject to stricter standards that is predominantly engaged in activities that are financial in nature or incidental thereto

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may require the Federal Reserve to consider whether the company should be exempted from the requirement to establish a section 6 holding company. In addition, the Federal Reserve Board may exempt a section 6 holding company from certain requirements otherwise applicable to a section 6 holding company, such as the requirement to conduct activities that are financial in nature or incidental thereto through the section 6 holding company and the affiliate transaction requirement discussed below. The requirements of section 4 of the Bank Holding Company Act will not apply to the activities that a foreign financial holding company conducts solely outside the United States. The Federal Reserve is also directed to "flexibly adapt" the activity and ownership restrictions of section 4 to financial holding companies subject to stricter standards.

Systemic Risk Regulation

Stricter Prudential Standards (Parent). The Federal Reserve must impose stricter prudential standards on financial holding companies that have been identified by the Council as being subject to stricter standards. These standards must include (i) risk-based capital requirements and leverage limits (unless the Federal Reserve determines such requirements are not appropriate to a financial holding company because of its activities or structure, in which case the Federal Reserve will apply other standards that result in appropriately stringent controls); (ii) liquidity requirements; (iii) concentration limits; (iv) prompt corrective action requirements; (v) resolution plan requirements and (vi) overall risk management requirements. The Federal Reserve may establish short-term debt limits and any other prudential standards that the Federal Board deems advisable, including taking actions to mitigate systemic risk. A financial holding company subject to stricter standards must at all times be "well capitalized" and "well managed," as to be defined by the Federal Reserve. If the Council determines that the size or other characteristics of a financial holding company subject to stricter standards pose a "grave threat" to U.S. financial stability, the Council shall require the company to undertake one or more mitigatory actions. These mitigatory actions include terminating activities, imposing additional conditions on activities, restricting the ability to offer a financial product or the ability to merge or acquire other entities, and, if the preceding actions are deemed inadequate by the Council, requiring the divestiture of business units or assets.

The Federal Reserve must impose stricter prudential standards on financial holding companies that have been identified by the Council as being subject to stricter standards.

Other Required Standards (Parent). The Act provides for the following specific standards applicable to a financial holding company subject to stricter standards: (i) a debt to equity ratio of no more than 15 to 1, (ii) capital requirements that must take into account off balance sheet activities and (iii) a prohibition from having credit exposure to any unaffiliated company that exceeds 25% of the company's capital stock and surplus, or such lower amount as the Federal Reserve may determine by regulation to be necessary to mitigate risks to financial stability.

Additional Requirements (Parent). A financial holding company subject to stricter standards (i) will be subject to an annual stress test conducted by the Federal Reserve, (ii) will be required to develop a plan designed to assist in the rapid and orderly resolution of the company, (iii) may be prohibited from engaging in proprietary trading, if the Federal Reserve determines that propriety trading by the company poses an existing or foreseeable threat to the safety and soundness of the company or to the financial stability of the United States and (iv) may, subject to Federal Reserve regulations, be required to maintain a minimum amount of contingent capital, i.e., long-term hybrid debt that is convertible to equity when the company fails to meet prudential standards established by the Federal Reserve and the Federal Reserve determines that threats to U.S. financial system stability make such a conversion necessary.

Stricter Prudential Standards (Functionally Regulated Subsidiaries). The Federal Reserve may recommend that the Federal financial regulatory agency for any "functionally regulated subsidiary" (as defined under the Act, this term does not include insurance companies) of a financial holding company subject to stricter standards impose stricter prudential standards on that functionally regulated subsidiary. The Federal financial regulatory

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agency must notify the Council and the Federal Reserve as to whether and to what extent the agency has imposed the recommended stricter prudential standards.

Prompt Corrective Action (Parent). A financial holding company subject to stricter standards that is incorporated or organized in the U.S. will be subject to a prompt corrective action regulatory regime similar to that currently imposed on U.S.-insured depository institutions under the Federal Deposit Insurance Act. The prompt corrective action regime will require the Federal Reserve to take one or more specified actions when a financial holding company fails to meet the required minimum level of the relevant capital measure (to be determined by the Federal Reserve). Depending upon the level of the capital deficiency, the required regulatory actions include restrictions on capital distributions, affiliate transactions, asset growth and entry into new lines of business, as well as requirements to terminate activities or divest subsidiaries.

Stricter Prudential Standards – Financial Activity or Practice. The Council may subject a financial activity or practice to stricter prudential standards if the Council determines that the conduct, scope, nature, size, scale, concentration or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit or other problems spreading among financial institutions or markets and thereby threaten the stability of the financial system or economy. This authority would apply to a financial activity or practice of any financial institution and not just to a financial holding company subject to stricter standards. The Federal Reserve must recommend prudential standards to the appropriate primary financial regulatory agency to apply to such identified activities and practices. The Federal Reserve also must consult with the primary financial regulatory agency with respect to any standard that is likely to have a significant effect on such agency's regulated entities (and with respect to insurance companies, the Federal Insurance Office). The primary financial regulatory agency must notify the Council and the Federal Reserve as to whether and to what extent the agency has imposed the stricter prudential standards.

The Council may subject a financial activity or practice to stricter prudential standards if the Council determines that . . . such activity or practice could create or increase the risk of significant liquidity, credit or other problems spreading among financial institutions or markets.

Regulation of Thrifts and Their Parents

Savings and loan associations (thrifts) and their parents (savings and loan holding companies) are currently regulated by the Director of the Office of Thrift Supervision under the Home Owners' Loan Act. The Act establishes a Division of Thrift Supervision in the Office of the Comptroller of the Currency and provides that the functions of the Director of the Office of Thrift Supervision will be transferred to the Division of Thrift Supervision in the Office of the Comptroller of the Currency, except for functions relating to state savings associations, which will be transferred to the Federal Deposit Insurance Corporation (the "FDIC"). The Act provides further that the regulatory functions of the Director of the Office of Thrift Supervision under the Home Owners' Loan Act with respect to savings and loan holding companies that are fraternal beneficiary societies under section 508(c)(8) of the Internal Revenue Code or that are, with all of their affiliates on a consolidated basis, predominantly engaged in the business of insurance will be transferred to the Federal Reserve. The Federal Reserve will regulate such savings and loan holding companies under the relevant provisions of the Home Owners' Loan Act. As explained below, other existing savings and loan holding companies will become subject to regulation by the Federal Reserve under the Bank Holding Company Act.

Other Bank Holding Company Act Amendments

Bank Holding Company Act Exceptions. Under the existing Bank Holding Company Act, a company that controls a thrift or an industrial loan company is exempt from regulation by the Federal Reserve as a bank

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holding company. Under the Act, the exception for a company that controls a thrift will extend only to a company that is a fraternal beneficiary society or that is, together with all of its affiliates on a consolidated basis, predominantly engaged in the business of insurance. Any other company that controls a thrift will be required to register as a bank holding company. The exception for a company that controls an industrial loan company will also be eliminated. However, the Act adds special provisions for certain qualifying unitary savings and loan holding companies and certain qualifying industrial loan holding companies that will continue to be exempt from general regulation by the Federal Reserve as bank holding companies, but will be required to establish a section 6 holding company, as described below.

Section 6 Holding Company. The Act provides for a new section 6 of the Bank Holding Company Act that sets forth special requirements for an intermediate holding company called a "section 6 holding company." As noted above, a financial company that is not a bank holding company at the time it is subjected to stricter standards will (subject to certain exceptions) be required to establish and conduct all financial activities through an intermediate holding company (a section 6 holding company) if the company conducts any activities that are not financial in nature or incidental thereto. Similarly, a qualifying unitary savings and loan holding company or industrial loan holding company will also be required to establish a section 6 holding company. Subject to certain exceptions, all financial activities are to be conducted through the section 6 holding company and its subsidiaries and all non-financial (commercial) activities are to be conducted outside the section 6 holding company. Subject to certain exceptions, transactions between a section 6 holding company (and any non-bank subsidiary thereof) and any affiliate not controlled by the section 6 holding company will be subject to the restrictions and limitations on affiliate transactions contained in Sections 23A and 23B of the Federal Reserve Act. No less than 25% of the members of the board of the section 6 holding company (and each subsidiary thereof) must be independent of the parent company. No executive officer of a section 6 holding company (or any subsidiary thereof) may serve as a director, officer or employee of any affiliate of the section 6 holding company that is not a subsidiary of the section 6 holding company. Furthermore, a company that directly or indirectly controls a section 6 holding company must serve as a source of strength to the section 6 holding company.

> **[T]he Act is designed to allow for resolution of a systemically important financial company by the FDIC outside of the constraints of the U.S. Bankruptcy Code and for the assessment of large financial companies to fund such a resolution.**

Enhanced Dissolution Authority

Generally. This part of the Act is designed to allow for resolution of a systemically important financial company by the FDIC outside of the constraints of the U.S. Bankruptcy Code and for the assessment of large financial companies to fund such a resolution. A Systemic Dissolution Fund ("Fund") will be established and pre-funded by assessments on large financial companies.

Resolution Determination – Covered Financial Company. Under the Act, if the Secretary of the Treasury (in consultation with the President) makes a systemic risk determination with respect to a financial company, the Secretary must appoint the FDIC as receiver for the financial company (a so-called "covered financial company"). Such a determination may be made only with respect to a company that is incorporated or organized under Federal law or the laws of any state; and is: (i) a bank holding company; (ii) a company that has been subjected to stricter prudential regulation (as discussed above); (iii) an insurance company; (iv) a company predominantly engaged in activities that are financial in nature or incidental thereto or identified for stricter prudential standards; or (v) any subsidiary of companies described in clauses (i) through (iv) (other than an insured depository institution or any registered broker or dealer that is a member of the Securities Investor Protection Corporation). The Secretary will act in the first instance upon the written recommendation from the Federal Reserve and the board or commission of the appropriate regulatory agency, as applicable. The appropriate

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regulatory agency will be the Securities Exchange Commission if the financial company, or one of its affiliates, is a registered broker or dealer, or the domestic state insurance regulator if the financial company, or one of its affiliates, is an insurance company. Otherwise, the FDIC will be the appropriate regulatory agency.

Consultation; Covered Subsidiaries; Insurance Companies. The FDIC, as receiver, must consult with the regulators of the covered financial company and its covered subsidiaries and must coordinate with the primary regulators of any subsidiaries that are not covered subsidiaries regarding treatment of solvent subsidiaries and separate resolution of insolvent subsidiaries under other governmental authority. Covered subsidiaries include all subsidiaries other than an insured depository institution or a registered broker or dealer that is a member of the Securities Investor Protection Corporation. A special provision requires that the resolution of an insurance company, whether a parent or subsidiary, be conducted under applicable state law. The FDIC, however, would be given backup authority to initiate a state law resolution proceeding if the appropriate state regulatory agency does not act after a systemic risk determination.

Resolution Scheme. Resolution under the Act will be pursuant to a scheme similar to the resolution scheme currently applicable to insured depository institutions under the Federal Deposit Insurance Act. Several additional features have been added to the resolution scheme. One such feature provides that, in any receivership of a covered financial company in which amounts realized from the resolution are insufficient to satisfy completely any amounts owed to the U.S. or to the Fund, an allowed claim under a legally enforceable or perfected security interest arising under a qualified financial contract with an original term of 30 days or less, secured by collateral other than securities issued by the U.S. Treasury, U.S. agencies and U.S. government sponsored enterprises, may be treated as an unsecured claim in the amount of up to 10%, as necessary to satisfy any amounts owed to the U.S. or to the Fund. The balance of such claim that is treated as an unsecured claim will be paid as a general liability of the covered financial company.

[T]he Act requires the FDIC to impose risk-based assessments on financial companies to capitalize the Fund at a minimum amount of $150 billion.

Assessments. In an effort to avoid having taxpayers directly support future resolution of troubled financial companies, the Act requires the FDIC to impose risk-based assessments on financial companies to capitalize the Fund at a minimum amount of $150 billion. If the Fund falls below this minimum threshold, additional assessments are required to replenish the Fund. The FDIC may only assess financial companies with $50 billion or more in assets on a consolidated basis or financial companies that manage hedge funds with $10 billion or more of assets under management. Assessments can vary based on various stated factors, including the extent to which the assessed financial company presents systemic risk or would benefit from the resolution of a failed financial company and whether assessments are imposed on a financial company or its affiliates under other federal or state assessment systems. The FDIC is required to differentiate among financial companies subject to assessment based on complexity of operations or organization, interconnectedness, size, direct or indirect activities and any other factors the FDIC or the Council may deem appropriate to ensure that the assessments charged equitably reflect the risk posed to the Fund by particular classes of financial companies. Because of the controversy surrounding the assessment process, the Act also provides that the Secretary of the Treasury must carry out a study analyzing how the new resolution authority should be funded. ■

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